Sagging U.S. gas output sets stage for higher prices

NEW YORK, May 31 (Reuters) -

A steep drop in U.S. natural gas output this year could mean big price jumps this summer and again this winter if the mercury lingers for long at either end of the thermometer, industry analysts said.

Despite a huge inventory overhang left after a record mild winter, analysts said a dramatic slide in production last year after drilling was slowed by a steep fall in prices sets the stage for a firm price environment well into next year.

"Demand has been going up and productive capacity has been declining, and that's an alarming trend. The storage situation may take some of the heat off the market, but I think high prices will be around for some time," said Kevin Petak at consultants Energy and Environmental Analysis in Virginia.

Petak said he expects prices at Henry Hub, the industry's benchmark pricing point in Louisiana, to average $3.10 per million British thermal units this year before jumping to $4.30 in 2003.

SINKING PRODUCTION

Many analysts said they were shocked by industry data showing a 3 percent first quarter skid from the previous quarter and almost 5 percent from a year ago.

And some said the U.S. Energy Information Administration's forecast for a 2 percent production drop this year was way too conservative, predicting supplies would slip some 3 percent to 5 percent.

At the same time, an economic upswing is expected to lift gas consumption by 2 percent to 3 percent, with the largest gain coming from the record 60,000 megawatts of new gas-fired power generation expected to come on line this year.

Even though mild, late spring weather has recently pulled Hub prices back into the $3.20s from near $3.80 last month, analysts said the new gas-fired power generators should tighten the balance this summer when air conditioners start humming.

"We see a tight market this summer and winter, and the main factors are the economic turnaround and increased demand for power generation," said Mary Menino at Energy Security Analysis (ESAI), a Massachusetts-based energy research firm.

PRICE SPIKES POSSIBLE

Even with U.S. gas inventories likely to climb to a healthy 3.1 trillion cubic feet by the Nov. 1 start of the heating season, analysts say sharp price spikes are possible, particularly if winter gets off to an early start.

Utilities and big industrial users typically build supplies from April through October to meet winter heating demand.

While most were not looking for a repeat of December 2000, when low stocks and a record cold start to winter sent prices soaring to $10.00, Petak did not rule out a brief spike to that level if the "right" conditions fall in place.

"If we get a real cold winter, we could see a repeat of 2000-2001. Producers are going to have to run pretty hard to keep up with demand through 2004," he said.

ESAI's Menino expects Hub prices to climb to $3.80 in the fourth quarter and average about $3.25 for the year. By 2003, she said economic growth and the start-up of more gas-fired power plants could push Hub gas to about the $4.00 level.

"I don't see $10 gas this winter. We're likely to have full storage which we didn't have two years ago, but we could see spikes if we get severe weather because production will still be pretty tight," she said.

DRILLING REVIVAL TAKES TIME

And despite a rising rig count this year as $3.00-plus gas stirs more interest in drilling, analysts said it will take a year or more to offset the current slump in production, too late to help consumers this winter.

"We need 900 gas rigs just to arrest the decline in production," said Greg McMichael, vice president at A.G. Edwards in Denver.

The latest data from oil services firm Baker Hughes showed 725 drilling rigs searching for natural gas, up sharply from the early April low of 591 but well below the 1,030 rigs active last year at this time.

McMichael also said price spikes were possible this year but were more likely to occur during winter, when cold weather and a late-year pickup in industrial demand further tighten the overall supply-demand balance.

Manufacturing accounts for some 40 percent of total gas demand. "We could see a summer spike above $4.00, but there's plenty of hydro (power) in the Northwest this year to offset the new gas-fired generation," McMichael said.

"Demand goes away pretty quickly when prices get above $5.00," he added, noting fertilizer and aluminum plants often slow production or shut when gas prices get too high.

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